EFFECT OF HOUSING FINANCE ON FEDERAL RESERVE POLICIES

STATEMENT PREPARED BY MARRINER S. ECCLES, MEMBER OF BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, AT REQUEST OF SENATOR J. WILLIAM FULBRIGHT, OF ARKANSAS, AND PLACED IN CONGRESSIONAL RECORD OF MARCH 15, 1950

Under Title III of Senate Bill 2246—the Housing Act of 1950—the obligations which would be issued by the proposed National Mortgage Corporation for Housing Cooperatives would compete directly with Government securities in the money market. They would be purchased largely by banks and other investors, which otherwise would probably hold Government securities. As a result, either the Federal Reserve would have to purchase additional Government securities, thus creating new bank reserves, or prices of Government securities would decline, i.e., interest rates would rise.

Although the protective aspects of the Corporation's obligations authorized by the bill are designed to be similar to those of FHA mortgage insurance, there are important differences between the two. Apart from the original capital of the Corporation, the funds extended by the Corporation would be private funds, but the ultimate lender, i.e., the purchaser of the debenture, is more adequately protected against difficulties and risk of loss than is the mortgagee or holder of an FHA-insured mortgage. If the Corporation defaults on a debenture, it itself makes the exchange for a guaranteed debenture, whereas if an FHA mortgagor defaults on his mortgage, FHA makes the exchange of the mortgage for a guaranteed debenture after the mortgagee has foreclosed and obtained title to the property. It would be reasonable to expect, moreover, that the Corporation would have less occasion to issue guaranteed debentures because, while FHA issues guaranteed debentures for every individual mortgage which is foreclosed, the Corporation would not have to issue guaranteed debentures in exchange for its other debentures until a very large proportion of its mortgages had gone bad and its capital, surplus, and reserves had been impaired to a point where the Corporation could not meet its obligations.

For these reasons and because of the other safeguards, the Corporation's debentures issued to obtain new funds should have an even more favorable market than the obligations of other Government corporations, such as Federal Land Banks, which are not protected in the same manner, and would be in effect the same as guaranteed Government securities. The competition which would arise in the market between Government securities and obligations of the Corporation would, therefore, be very direct. Most of the buyers of the debentures would be banks, institutions, and other investors that would probably otherwise hold Government securities.

As the bill stands, the Corporation would have a great deal of discretion about the gross interest rate to charge borrowers and the mortgage maturities to permit. The Corporation would probably be able to borrow at slightly above the long-term Government rate, and the lowest gross rate to borrowers might be little over 3 per cent, although it would have the authority to charge higher rates and build up reserves. On the other hand, by issuing short-term debentures, the Corporation might get its money as low as 1¼ or 1½ per cent, which might permit a gross rate much lower than 3 per cent.

If the Corporation were to obtain funds for long-term mortgage lending by borrowing substantial amounts on short-term obligations, it would not only run the risk of adverse market fluctuations, but it would in all likelihood obtain these short-term funds largely from expansion of bank credit. This could be undesirable in a period when general credit policy was directed toward limiting expansion of bank credit.

In view of the safeguards with respect to capital of the Corporation and insurance reserves against the debentures included in the law, it is unnecessary to add the undesirable feature of what is in effect a direct Government guarantee of the debentures. The Corporation should be able to borrow on terms just as favorable as the Federal Land Banks and the Home Loan Banks, which now have no such guarantee. The debentures then would be more truly of the nature of private obligations and compete less directly with Government securities.

The practice of issuing securities guaranteed by the Federal Government was abandoned many years ago because such issues came to be viewed as practically the same as direct Government obligations and were an indirect means of keeping the expenditures out of the budget. Issuance of guaranteed obligations has the same effect as an increase in the public debt. Investors buying the new securities might sell direct obligations of the Government. Either the prices of Government securities would fall and interest rates rise or the Federal Reserve would have to support the market by buying securities, thus creating bank reserves.

Action by the Federal Reserve of this nature might at times be inconsistent with major aims and statutory obligations of the Federal Reserve. An excellent description of the appropriate aims and procedures of Federal Reserve policies is given in a recent report of the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, after conducting a comprehensive inquiry under the Chairmanship of Senator Douglas. This description may be summarized and paraphrased approximately as follows:

The role of the Federal Reserve in our economy is to supply the banking system with adequate lending power to support a growing and relatively stable economy and to exercise restraint upon excessive credit expansion that will lead to instability. This task has been made exceptionally difficult by the tremendous wartime growth of the public debt, the pervasive distribution of Government securities among many holders, and the tendency of these holders to view their securities as liquid assets readily convertible into money to be spent or otherwise invested. Attempts to sell these securities, unless buyers are readily available, tend to lower their prices, which means a rise in interest rates. In the absence of a demand by other investors, declining prices can be prevented only by Federal Reserve purchases. But any expansion of Federal Reserve credit has the effect of supplying banks with additional reserve funds, on the basis of which the banking system by lending or investing and relending can expand bank credit, and the volume of money, by many times the amount of the reserves supplied.

This process of monetary inflation can be somewhat restrained by limiting Federal Reserve purchases of Government securities. As the Douglas Subcommittee report pointed out,[1] "the essential characteristic of a monetary policy that will promote general economic stability is its timely flexibility." But Federal Reserve policies cannot be varied in response to changing needs without affecting interest rates. For the Federal Reserve to endeavor to maintain a rigid level of interest rates would mean supplying all credit demands in time of expansion and absorbing all of the unused supply of credit in times of contracting demands. Such policies would tend to create instability, because they would tend to reinforce both the expansion and the contraction phases of economic fluctuation.

Another general point which should be kept in mind is that there are many interest rates which reflect, on the one hand, varying degrees of risk and liquidity involved in different obligations and, on the other hand, the supplies of funds that may be seeking relative safety and liquidity at the sacrifice of higher return or vice versa. For example, the Treasury can borrow at between 1 and 1¼ per cent on short-term obligations and at less than 2½ per cent on long-term bonds, while business borrowers at banks pay from 1½ to more than 6 per cent, depending on the size and risk of the loan, and consumer loans carry higher interest charges. These differences in the structure of interest rates must be taken into consideration in the determination of Federal Reserve policies.

What bearing do these observations have on housing finance and housing legislation? An important aspect of most of the housing legislation of the past two decades has been to make it possible for lenders to tap money markets at lower rates of interest and on more favorable terms than were previously available. These were and are, on the whole, desirable aims, as institutional arrangements in the mortgage market have had much need for improvement. Particularly during periods of depression and substantial unemployment it was most helpful to facilitate the flow of available investable funds into the mortgage market at reduced rates of interest. It is quite another matter, however, to adopte measures which will lead to the creation of new money to finance construction at a time when activity is already fully utilizing available supplies

[1] "Monetary, Credit, and Fiscal Policies", Report of the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, January 23, 1950, p. 19.

of material and labor and prices are higher than a large portion of potential buyers can afford.

The aim of many of the measures adopted and proposed has been to lower the cost of housing by obtaining low interest rates on mortgages—an important cost of home ownership. This is generally done by attaching some sort of Government insurance or guarantee to the mortgages or to the obligations of mortgage lending agencies or by providing facilities for increasing their liquidity. One result is that these obligations can tap sources of lendable funds that would otherwise not have been available to them. The lower rates and increased availability of funds tends to stimulate borrowing.

Obligations guaranteed or insured by the Federal Government are to a considerable degree competitive with Government securities; therefore an increase in such obligations is likely to result in a decline in prices of Government bonds, i.e., a rise in interest rates. In the absence of a large unused supply of loanable funds in that sector of the market, the only way a general rise in interest rates could be avoided would be by Federal Reserve purchases of Government securities, which would mean the creation of new money.

Thus the issuance of additional amounts of obligations directly or indirectly guaranteed by the Federal Government would have the effect either of depressing the prices of Government securities or of requiring creation of supplies of new money by the Federal Reserve. In the case of the first alternative, the benefits of lower interest rates expected by the sponsors of the measures to provide cheaper housing would not be fully realized and, in addition, all other Government securities would decline in price. In the latter case the inflationary policies might result in higher prices. Whether such a result ensues depends upon the general economic situation at the time.

It is because of these possible consequences that the Federal Reserve has a particular interest in housing finance and in the various legislative proposals that have been made. Their effects on the economy, and perhaps their success in accomplishing their objectives, will in the final analysis influence, or be influenced by, Federal Reserve policies.

While the monetary consequences of financing the amount of debentures proposed under the present bill might be slight, the principle, however, is one which, if adopted in a moderate amount for one purpose, might well be extended in magnitude and scope. It is difficult to provide special privileges to one group and deny them to others. This principle, if widely adopted, could unduly stimulate housing construction at lowered interest costs and eventually undermine the values of existing houses and of mortgages outstanding against them. It would be at first an inflationary factor and ultimately lead to a deflation of values.